True Grit
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Dear Fellow Investors:

I am a big Coen Brothers fan and they recently remade the movie, True Grit. It is the story of a young girl who hires a bounty hunter to chase down the man who murdered her father. In the process of bringing the murderer to justice, they sought to put her father's estate to rest and settle up the family finances.

Jeff Bridges, who has really found his acting niche, plays the Marshall she hires to chase the murderer down. His skill and savvy are accented with great courage. His alcoholism is a definite detractor, but with True Grit they get their man. Even when you know what the final outcome is in a story, it is always fun to see how it plays out.

When you position yourself in investment markets, the same thing happens. You know that ultimately all speculative episodes end. What you don't get to know is when. This is true even during the last year of these episodes, when it seems obvious you are right but the market continues in its maniacal direction.

In 1999, it was only a matter of time before dot-com companies and over-valued tech shares were headed for a crash. However, it took True Grit to stay away as the NASDAQ and Tech-heavy S&P 500 Index soared.

In 2005, residential property prices exploded in Miami, Los Angeles, Phoenix and Las Vegas. Condo and house speculators (flippers) became rabid and numerous. When houses doubled in four years, you knew to call the Marshall and avoid participation.

The few sophisticated and savvy hedge fund managers who invested in Credit Default Swaps in 2007 knew for a year that the mortgage meltdown would make them rich. Major mortgage-oriented financial institutions and hedge funds were imploding in 2007, but it was well into 2008 when most of the participants figured out that the CDS contracts were the thing to buy to profit from the financial system debacle. These investors showed savvy and were as right as they could possibly have been, yet had to show True Grit. They held these securities without any reinforcement.

We have the same kind of situation in China. The Totalitarian Communist Government controlled banks loaned $1.5 trillion for real estate construction in 2009-10. Communist party member, Yin Zhongqing, shared recently that 70 percent of those loans won't be paid back.

BEIJING: Billions of dollars of debt racked up by local Chinese governments during their investment sprees are likely to sour as the projects they finance near completion, Yin Zhongqing, a prominent Chinese lawmaker, said this week.

"Seventy percent of the loans from these investment and financing platforms in 2009 and 2010 were generated at the county level, where governments don't have much assets, and some cannot even afford to pay their staff," he said.

"Debts accumulated from these platforms, even with government financial guarantees, simply cannot be paid back. In other words, when they borrowed the money, local governments did not plan to pay it back."

Instead of homes going up 100% in four years like we had at the height of the real estate bubble here in the US, it has been even steeper in China. At an Outlook 2011 talk I did in January a man came up and told me that both of his brother-in-laws are Chinese citizens. One bought a house two years ago and the other one about 18 months ago. Both have seen the price of their home double! The result of this boom in lending is massive mispricing of everything from Commodities to Emerging Market stocks and bonds. In the US, it means over-priced export-oriented cyclical stocks and confidence in energy demand. It takes savvy and great courage to avoid this mania.

As is usual, we are a few years into avoiding this mania and other than riding along with the bull market in stocks, we don't have the reward for standing against it. Economist Andy Xie explained on Bloomberg on February 9th that China would need to raise their interest rates by 2.5% to get ahead of the inflation caused by their uninterrupted GDP growth. So far they have settled for minor rate increases and higher reserve requirements in hope of getting a “soft landing”. Since we’ve never seen or read about a speculative episode ending softly, we continually re-screen our portfolios to protect against companies which develop a "China" premium.

The reason to avoid these manias with True Grit and give up the last exciting appreciation toward the end was exposed in the movie. Rectifying a mania is as bloody as the final scenes of the movie. The murderer and his gang get their comeuppance in a violent way. Just ask former tech bubble participants, condo flippers or mortgage executives how things were in the first years after the mania breaks.

We believe a whopper of a recession is coming in China. In our mind, it is only a question of when. Until then we will practice True Grit in our portfolio management and wait for history to repeat in the way we believe is inevitable.

Best Wishes,

William Smead

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